19 19 17 17

Nos. 84-871, 84-889, 84-1054, and 84-1069

In the Supreme Court of the United States

OCTOBER TERM, 1985

LOUISIANA PUBLIC SERVICE COMMISSION, APPELLANT

v.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

PUBLIC UTILITIES COMMISSION OF OHIO, ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

FLORIDA PUBLIC SERVICE COMMISSION, PETITIONER

v.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

ON APPEAL AND ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS

JACK D. SMITH
General Counsel

DANIEL M. ARMSTRONG
Associate General Counsel

JOHN E. INGLE
Deputy Associate General Counsel

JANE E. MAGO
Counsel
Federal Communications Commission
Washington, D.C. 20554

CHARLES FRIED
Solicitor General

LAWRENCE G. WALLACE
Deputy Solicitor General

CHRISTOPHER J. WRIGHT
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

57

QUESTION PRESENTED

Whether the court of appeals correctly held that the Federal Communications Commission acted within the scope of its authority in determining that its prescription of certain depreciation practices for telephone equipment preempted state commissions from prescribing inconsistent depreciation practices.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Cases—Continued: Page

Constitution, statutes and regulation:

Miscellaneous:

In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 84-871

LOUISIANA PUBLIC SERVICE COMMISSION, APPELLANT

v.

FEDERAL COMMUNICATIONS COMMISSION and UNITED STATES OF AMERICA

No. 84-889

CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION and UNITED STATES OF AMERICA

No. 84-1054

PUBLIC UTILITIES COMMISSION OF OHIO, ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION and UNITED STATES OF AMERICA

No. 84-1069

FLORIDA PUBLIC SERVICE COMMISSION, PETITIONER

v.

FEDERAL COMMUNICATIONS COMMISSION and UNITED STATES OF AMERICA

ON APPEAL AND ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS

OPINIONS BELOW

The opinion of the court of appeals is reported at 737 F.2d 388 and is reproduced in the Appendix to the Jurisdictional Statement in No. 84-871 at J.S. App. A1-A23. The order of the FCC (the *Preemption Order*) is reported at 92 F.C.C.2d 864 and is reproduced at J.S. App. A24-A60.

JURISDICTION

The judgment of the court of appeals was entered on June 18, 1984, and petitions for rehearing and suggestions of rehearing *en banc* were denied on October 3, 1984 (J.S. App. A90). The appellant in No. 84-871 filed its notice of appeal on November 30, 1984 (J.S. App. A92), and purports to invoke this Court's jurisdiction under 28 U.S.C. 1254(2). The petitions for a writ of certiorari in Nos. 84-889, 84-1054, and 84-1069 were filed on December 10, 1984, January 2, 1985, and January 2, 1985, respectively, and invoke this Court's jurisdiction pursuant to 28 U.S.C. 1254(1). The appellant in No. 84-871 asks the Court to treat its jurisdictional statement as a petition for a writ of certiorari pursuant to 28 U.S.C. 2103 if the Court determines that an appeal does not lie.[1]

STATUTES INVOLVED

The relevant portions of the Communications Act of 1934, 47 U.S.C. (& Supp. I) 151 *et seq.*, are reproduced in the appendix to this brief.

---

[1] The Court granted the petitions for a writ of certiorari and postponed jurisdiction on June 24, 1985. For the reasons stated in our motion to dismiss and brief in opposition (at 11-12), this case is not within the Court's appellate jurisdiction.

STATEMENT

The Communications Act of 1934 authorizes the Federal Communications Commission comprehensively to regulate interstate communications (47 U.S.C. 151, 152(a)), while reserving state jurisdiction over intrastate communications (47 U.S.C. 152(b), 221(b)). This case deals with the depreciation methods applied to telephone equipment that is used to provide both interstate and intrastate communications. In 1980 and 1981, the FCC adopted three depreciation policies for telephone equipment that are intended to bring depreciation regulation into harmony with the new competitive and technological realities of the industry. Unlike earlier FCC depreciation policies, which state regulatory agencies generally had followed, these changes were not embraced by many state agencies. On requests for clarification of the effect of the new policies on state regulation, the FCC concluded, in its *Preemption Order*, that the Act did not permit state commissions to require telephone companies to use depreciation methods and rates that are different from those prescribed by the FCC for the same equipment unless the FCC had expressly permitted exemptions for those companies. The FCC further found, as an alternative ground for preemption, that inconsistent state commission actions would frustrate the goals it sought to achieve when it adopted the new depreciation policies. The Fourth Circuit upheld the FCC's ruling on the alternative ground.

1. The Communications Act provides for complementary federal and state regulation. As a general rule, the nation's telephone companies provide interstate service under tariffs filed with the FCC and intrastate service under tariffs filed with state commis-

sions. Jurisdictional disputes under this scheme were infrequent until the mid-1970s. The FCC typically acquiesced in state regulation of most aspects of intrastate service, even where some interstate service might be affected, asserting the full breadth of its regulatory authority only where there was a need for uniformity in the rules governing jointly-used property or where federal policies might be undercut by fragmented regulation (J.S. App. A40). In recent years, however, federal policies encouraging competition sometimes have confronted state regulatory policies that are more conducive to the continued monopoly provision of services and equipment (J.S. App. A41). In several instances, the FCC has asserted its own authority as paramount and has declared conflicting state regulation invalid.[2]

This case deals with depreciation accounting, which is the process of charging the cost of depreciable property, adjusted for net salvage, to operating expense accounts over the useful life of the property. See National Association of Regulatory Utility Commissioners, *Public Utility Depreciation Practices* 35-52 (1968). Depreciation accounting affects the rates customers pay for telephone service. A regulated carrier is entitled to an opportunity to earn a fair return on its investment and to recover its reasonable expenses through its rates for service. The total amount the carrier is entitled to charge its customers, known as its "revenue requirement," is the total of its current operating expenses, including taxes and depreciation expenses, and a return on its invest-

[2] The courts uniformly have affirmed the FCC's assertions of primacy in the regulation of jointly-used communications services and facilities where the FCC's substantive actions were within its statutory authority. See pages 18-19 & note 17, *infra*.

ment rate base.[3] Depreciation accounting affects both the rate base and operating expense accounts. The original cost of a given item of equipment goes into the rate base when that item enters service. As the item depreciates over time—as a function of "wear and tear" or technological obsolescence—the amount in the rate base is reduced according to a schedule that is based on the item's expected useful life. Each year the amount removed from the rate base is included as an operating expense.[4] The annual depreciation charges accumulate in an account known as the depreciation reserve, which should equal the depreciable cost of the item at the end of the process. The depreciation reserve is a measure of the extent to which the carrier has recovered its investment in equipment. See P. Garfield & W. Lovejoy, *Public Utility Economics* 94-114 (1964).

The Act gives the FCC authority to prescribe depreciation practices for communications carriers. Section 220(b) authorizes the FCC to prescribe "classes of property" for which depreciation may be charged and to prescribe depreciation procedures; it states that the carriers "shall not" use any other

[3] Regulators can affect the size of the revenue requirement in various ways. They can, for example, disallow specific expenses, disallow inclusion of items in the rate base, and alter the rate of return allowed on the rate base. See P. Garfield & W. Lovejoy, *Public Utility Economics* 44-83 (1964).

[4] For example, a truck with an original cost of $10,000 and an expected life of ten years enters the rate base as a $10,000 item to be depreciated over ten years. If we assume for the sake of simplicity that the truck has no salvage value, each year's depreciation would diminish the rate base by $1,000 and add an expense charge of $1,000 to the revenue requirement for that year.

classifications or depreciation procedures. The FCC is required, before prescribing any depreciation procedures, to "notify each State commission" and to "receive and consider" the views and recommendations of such commissions (Section 220(i)). The FCC may except the carriers in any state from its prescribed depreciation procedures, where such carriers are subject to state commission regulation, "if it deems such action consistent with the public interest" (Section 220(h)).

The FCC prescribes depreciation rates on a company-by-company basis for about one-third of the nation's largest telephone companies every year; thus, the depreciation rates for each of these companies are revised every three years. A practice has developed over the years in which representatives of the FCC, individual carriers, and the appropriate state commission hold "three-way meetings" to develop depreciation rates that are consistent with the FCC's more general depreciation policies before the FCC actually prescribes particular rates for individual carriers. See, *e.g.*, *Prescription of Revised Percentages of Depreciation*, 88 F.C.C.2d 1223, 1225 (1982). Through those meetings, the FCC generally has been able to accommodate the special concerns of state commissions without compromising its own depreciation policies unduly. The FCC has allowed exceptions from general rules for carriers in particular states, as Section 220(h) permits, where that would not undermine federal policy or conflict with the public interest. See, *e.g.*, *In re Amendment of Part 31*, 68 F.C.C.2d 902, 906-907 (1978).

2. The two substantive FCC orders that preceded the *Preemption Order* made three changes in the agency's depreciation prescriptions. In *In re Property Depreciation (ELG Order)*, J.A. 4-44, reconsideration denied, J.A. 45-65, the FCC substituted "equal life group" (ELG) depreciation in place of "vintage grouping." [5] Grouping of telephone company equipment for depreciation purposes is required because telephone companies have so many individual items of equipment that it is not practical to depreciate each item individually. Under vintage grouping all items of a similar type installed in a year are depreciated over the average useful life for the group, even though the group might contain equipment with widely varying life expectancies. Under the equal life group method, the groups are smaller and include only those items whose expected lives are

[5] The Commission initiated this proceeding in response to a petition by the American Telephone and Telegraph Company, which had argued that its depreciation reserve under the old depreciation policies did not reflect the true rate of decrease in the value of its plant in the new era of competition and technological innovation. J.A. 4-6. The Commission considered AT&T's request in light of several rounds of comments from the industry, accounting firms, and state regulatory commissions; an independent accounting study commissioned by the FCC; and revenue impact studies by the two largest telephone carriers. J.A. 6-7. In general, the telephone carriers and accounting firms supported depreciation reform, and the state commissions opposed any change. Although the FCC generally adopted the depreciation methods advocated by the carriers, it took several actions to accommodate state concerns. For example, it permitted ELG accounting methods prospectively only and phased in the new policies so as to mitigate their potential impact on ratepayers and lessen the additional work burden they would impose on state regulators. J.A. 29-30. It also directed its staff to monitor the effects of the new policies on rates and to inform the Commission of any significant rate increases that might be attributable to the changes. J.A. 35-36.

approximately equal.[6] The principal advantages of the ELG method are greater accuracy in allocation of costs and faster capital recovery for equipment with shorter lives. J.A. 23.[7]

The second revision in the *ELG Order*—adoption of the "remaining life" method in place of the "whole life" method (J.A. 33-36)—deals with the problem of correcting for errors in forecasts of useful life. Under the whole life approach, the FCC had required carriers to calculate depreciation charges each year as if the useful life of assets had been correctly estimated from the beginning, even when that estimate had been erroneous. Under whole life accounting, when there was an error in the initial life estimation, the assets affected by the error would be either under-recovered or over-recovered at the time of their retirement.[8] The remaining life method permits a correction for erroneous forecasts of the length of useful life. This method permits carriers to allocate any unrecovered depreciation over the corrected remaining life estimate and helps overcome the depreciation reserve deficiencies that had become evident in the modern telephone industry.[9]

[6] For example, a vintage group might include all the new cable purchased in a given year, even though some of the cable might be expected to last several times as long as some other cable. The "life" for the vintage group would be the average life for all items in the group. In contrast to vintage grouping, there might be several equal life groups of cable for a single year. Equal life groups might include all the new outdoor cable purchased in a given year, with an expected useful life of five years, and all the new indoor cable purchased in a given year, with an expected useful life of fifteen years.

[7] The depreciation method is the same under equal life and vintage grouping: straight-line depreciation over the average life of the items in the group.

[8] In the industry environment that existed until the late 1960s, these errors tended to balance out. The FCC found, however, that new technology and competition had changed this through an overall shortening of useful lives. J.A. 34. Thus, it was no longer valid to assume that errors of overestimation and underestimation were "self balancing." *Ibid.*

The Commission anticipated that these depreciation policies would produce more timely capital recovery for telephone carriers and result in faster technological innovation with accompanying benefits for the public—such as more efficient service and eventually lower costs from more productive use of telephone facilities. J.A. 23-24. It recognized that the new policies would likely produce a temporary increase in telephone rates (J.A. 23, 35), but it concluded that the longer-term costs to society of maintaining the existing system far outweighed the short-term advantages of holding down depreciation expenses. If it did not initiate depreciation reform, the Commission said, much larger adjustments would be necessary at some future date. J.A. 40.

[9] For example, an asset might be depreciated at 10% a year on the assumption that it would last for ten years. In the fourth year, after 30% depreciation, the "correct" useful life estimate might be revised to five years because of technological or competitive developments that would hasten the asset's obsolescence. Under the whole life method, the depreciation for the fourth and fifth years would be adjusted to 20% a year, on the new assumption that it was known all along that the asset would last only five years. But the total depreciation for this asset under that method would be only 70% of the depreciable cost—30% for the first three years and 40% for the last two. Under the remaining life method, the depreciation for each of the last two years in this example would be 35%, so as to recover all of the depreciable cost that remained unrecovered when the correction was made.

In *In re Uniform System of Accounts (Inside Wiring Order)*, 85 F.C.C.2d 818 (1981), the FCC determined that one class of property it earlier had prescribed as depreciable—inside wiring[10]—no longer should be capitalized and depreciated but should instead be treated as a current expense. Like the *ELG Order*, the *Inside Wiring Order* had its origins in relatively recent developments in communications markets and technology. The FCC decided that continuing to depreciate this expenditure over time had the same potential for out-of-phase capital recovery and for misallocation of costs among customers that had prompted the changes to equal life grouping and remaining life depreciation, and so it removed inside wiring from the prescribed list of depreciable property.[11]

---

[10] "Inside wiring" for purposes of this decision includes the costs of material and labor associated with the installation of wire inside the premises of a business or residence. It does not include categories of wire that are considered permanent and might properly be capitalized as investment in plant. 85 F.C.C.2d at 823-826.

[11] Competitive provision of many of the elements of station connections, including inside wiring, had made it necessary for the FCC to consider the propriety of continuing to impose such costs on the general body of ratepayers through capitalization and depreciation charges. The FCC decided that customers who had obtained station connections from sources other than the telephone company should not have to pay telephone rates that include depreciation and a return on investment generated by the telephone company's provision of station connections for other customers. The FCC already had concluded in a 1977 rate decision that "the causative ratepayer should bear the full burden of the costs of station connections." *In re AT&T*, 64 F.C.C.2d 1, 54-56 (1977). See also *Inside Wiring Order*, 85 F.C.C.2d at 819-820 (1979).

3. Although the FCC and the state commissions participating in these proceedings clearly anticipated an immediate effect on both interstate and intrastate rates (J.A. 23, 35), no one sought review of either the *ELG Order* or the *Inside Wiring Order*. However, two parties representing state commissions asked the FCC to clarify the preemptive effect of its depreciation decisions.[12] The Commission first decided, by a 4-3 vote, that its depreciation orders did not require the state commissions to follow the federal policy in their ratemaking proceedings.[13] On reconsideration the Commission unanimously ruled that state commissions had to follow the federal depreciation orders (J.S. App. A24-A60).[14]

The FCC decided on reconsideration that Section 220 of the Communications Act forecloses the states from adopting depreciation rates different from those the FCC has prescribed unless the FCC expressly has

---

[12] NARUC Petition for Clarification (in CC Docket No. 79-105) (filed Apr. 30, 1981); California PUC Petition for Reconsideration (in CC Docket No. 79-105) (filed Apr. 29, 1981).

[13] The Commission in that first decision held that Section 220 of the Communications Act in itself did not preempt the states from adopting accounting procedures that were different from those prescribed by the FCC (J.S. App. A61-A62). The majority recognized that the FCC's actions under Section 220 could preempt "state regulatory actions that might interfere with or tend to frustrate policies or rules we have adopted," but it saw "no occasion" to override state actions in this instance (J.S. App. A84).

[14] The FCC also granted a petition for a declaratory ruling, at the request of General Telephone Co. of Ohio, declaring that the Ohio Public Utilities Commission had acted inconsistently with the *ELG Order* when it had refused to allow rate increases that sought to implement the new depreciation rules (J.S. App. A48-A49).

excepted the carriers in particular states from its prescriptions. The Commission noted that, under the plain language of the statute, "the Commission 'shall' make depreciation prescriptions, and * * * carriers 'shall not' charge depreciation different than that prescribed by the Commission" (J.S. App. A32). The Commission added that other provisions of Section 220 are consistent with this plain language—Section 220(i) requires that "states be given an opportunity to comment" before the FCC prescribes depreciation practices (J.S. App. A32) and Section 220(h) gives the FCC discretionary authority to grant exceptions to its depreciation prescriptions for carriers in a particular state "if it deems such action consistent with the public interest" (J.S. App. A32). The legislative history also supports a plain reading of Section 220(b), the Commission concluded, because Congress considered and rejected a provision that would have given states the power to prescribe separate depreciation rules for intrastate purposes (J.S. App. A35-A37).

Alternatively, the FCC found that even if the statute itself does not preempt the states, preemption is necessary in this case to avoid frustration of the federal policies the FCC had adopted. The FCC had adopted its new depreciation rules to rationalize capital recovery throughout the entire telephone industry. Rational capital recovery, it concluded, was necessary to ensure continued development of the national telephone system and to further the FCC's policy of "encouraging competition wherever the market conditions will support such a policy and produce benefits to the public interest" (J.S. App. A44). The new depreciation prescriptions, it said, were needed to make the "marketplace * * * operate efficiently"

(*ibid.*). The Commission concluded that inconsistent state depreciation rules could give "improper signals * * * to the market" (J.S. App. A45). Indeed, since 75% of the cost of the affected equipment is allocated to the intrastate jurisdiction under separations procedures (see 47 U.S.C. 221(c), 410(c)), adoption of inconsistent depreciation measures by the states would likely "delay or prevent modernization" and could imperil the full recovery by the carriers of their invested capital (J.S. App. A46). The FCC concluded that "it is essential to preempt inconsistent state depreciation practices to avoid frustration of * * * vital national policies" (J.S. App. A48).[15]

4. The Fourth Circuit affirmed the FCC's *Preemption Order*, with one judge dissenting. The court of appeals found it "unnecessary to decide" whether Section 220(b) requires preemption as a matter of law (J.S. App. A8). Instead, relying primarily on this Court's decision in *Fidelity Federal Savings & Loan Ass'n* v. *de la Cuesta*, 458 U.S. 141 (1982), the court of appeals held that the FCC had lawfully exer-

---

[15] The FCC's concern that some states would not follow its depreciation prescriptions, already evident to some extent when it adopted the *Preemption Order*, has proven correct. Although an appellate review proceeding was initiated promptly in a court with jurisdiction to stay the FCC's *Preemption Order*, not one of the many state parties involved in that proceeding sought a stay. Yet a number of state commissions ignored both the substantive depreciation orders and the subsequent preemption decision in denying telephone company rate changes that were designed to carry out the FCC's prescriptions. See, *e.g.*, *Chesapeake & Potomac Telephone Co.* v. *Public Service Commission*, 560 F. Supp. 844 (D. Md. 1983), aff'd, 748 F.2d 879 (4th Cir. 1984), cert. granted, No. 84-1362 (June 24, 1985). That case will be argued in tandem with the present one.

cised its discretionary power to preempt so as to avoid frustration of valid federal policies. Under *de la Cuesta,* the court of appeals noted, the test is whether the FCC "meant to preempt, and whether such preemptive action is within the scope of the agency's authority" (J.S. App. A10, citing 458 U.S. at 154). Since the FCC clearly intended to preempt, the only issue was whether the FCC had acted within the scope of its authority.

The court noted that "improper capital recovery does pose a true threat in today's competitive market" (J.S. App. A12). The court recognized that the effects of inconsistent state depreciation regulation would not be limited to matters confined to the intrastate jurisdiction. If state depreciation practices failed to reflect actual depreciation rates properly, "interstate service would then suffer the effects of delayed innovation" because the same equipment is used for interstate and intrastate purposes (J.S. App. A13-A14). The court of appeals acknowledged that the FCC's decision would affect intrastate rates, but it held that "the effect will only be ancillary to the FCC's primary statutory directive to regulate interstate communications" (J.S. App. A11). The Fourth Circuit noted that its own prior decisions and those of other circuits uniformly permitted preemption by the FCC when that was necessary to advance federal policies, even though preemption would affect intrastate rates (J.S. App. A14-A16). The court concluded that the FCC had acted "within its authority to ensure efficient operation of the interstate telephone network" and that its preemption of inconsistent state regulation was therefore valid (J.S. App. A11).

SUMMARY OF ARGUMENT

The FCC may preempt states from requiring telephone companies to use depreciation methods and rates that are inconsistent with those prescribed by the FCC if its decision is reasonable and within the scope of its authority. The FCC's *Preemption Order* was a reasonable decision within the scope of its comprehensive mandate to make available an efficient national telephone network. Indeed, there can be no doubt about the FCC's authority to prescribe preemptive depreciation methods and rates, since Section 220 of the Communications Act plainly gives the FCC exclusive authority over depreciation practices unless the FCC determines that regulation by a state commission promotes the public interest. Contrary to petitioners' arguments, Section 152(b), which reserves state authority over purely intrastate matters, does not prohibit the FCC from prescribing preemptive depreciation methods and rates.

A. Section 151 of the Act directs the FCC to develop a national telephone network and Section 152(a) gives the FCC broad jurisdiction over interstate communications. The courts of appeals have recognized that these provisions give the FCC paramount authority over matters affecting interstate telephone service. In its substantive depreciation orders, the FCC reasonably determined that the changes it ordered promoted vital national policies, including timely recovery of capital invested in telephone equipment. Delayed capital recovery would discourage investment in modern equipment and therefore delay modernization. The goals the FCC sought to achieve in those orders would be frustrated if state commissions could order telephone companies to use different depreciation methods on telephone

equipment used jointly for interstate and intrastate communications.

B. Section 220(b) of the Act demonstrates beyond doubt that depreciation practices are within the scope of the FCC's authority. That section plainly states that once the FCC has prescribed depreciation methods and rates, telephone companies "shall not" use other methods and rates. The legislative history shows that Section 220(b) means what it says. The section was modeled on a provision of the Interstate Commerce Act that had been construed as providing exclusive federal authority over the depreciation practices of telephone companies. Representatives of state commissions recognized that and proposed that the Communications Act reserve authority to state commissions over depreciation rates to be used in intrastate ratemaking proceedings. Congress gave careful attention to that proposal and rejected it. Instead, Congress provided that state commissions must be consulted by the FCC before it prescribes depreciation methods and rates and authorized the FCC to permit state commissions to set depreciation rates where the FCC determines that such a course is in the public interest.

C. Petitioners' argument is based almost entirely on Section 152(b), which reserves state authority over intrastate communications. However, it is clear that the general provisions of Section 152(b) do not override the specific commands of Section 220(c). Moreover, as the courts of appeals have determined, Section 152(b) reserves state authority over purely intrastate matters only. This dispute does not involve a purely intrastate matter, because the telephone equipment involved is used for interstate and intrastate communications and state regulation could

frustrate federal policy. At most, Section 152(b) was designed to reserve state authority over the rates charged to customers for intrastate service, and the FCC has not usurped that authority.

ARGUMENT

THE FCC ACTED WITHIN THE SCOPE OF ITS AUTHORITY IN PREEMPTING STATE COMMISSIONS FROM REQUIRING TELEPHONE COMPANIES TO USE DEPRECIATION PRACTICES THAT ARE INCONSISTENT WITH THOSE PRESCRIBED BY THE FCC

A federal agency acting within its statutory authority may preempt inconsistent or conflicting state actions by virtue of the Supremacy Clause. See *Fidelity Federal Savings & Loan Ass'n* v. *de la Cuesta*, 458 U.S. 141 (1982). As this Court recently stated in *Capital Cities Cable, Inc.* v. *Crisp*. No. 82-1795 (June 18, 1984), slip op. 7, "[i]f the FCC has resolved to pre-empt an area of * * * regulation and if this determination 'represents a reasonable accommodation of conflicting policies' that are within the agency's domain, * * * we must conclude that all conflicting state regulations have been precluded" (quoting *United States* v. *Shimer*, 367 U.S. 374, 383 (1961)). The FCC's decision to preempt inconsistent state depreciation practices was permissible under this standard.

A. Section 151 Authorizes The FCC To Preempt In Order To Improve Interstate Telephone Service

Congress created the FCC for the purpose of centralizing in one agency the task of overseeing the communications industry in the United States and developing communications policies for wire and radio on an integrated basis. H.R. Rep. 1850, 73d

Cong., 2d Sess. 3 (1934). It gave the Commission "a comprehensive mandate" with "expansive powers." *National Broadcasting Co.* v. *United States*, 319 U.S. 190, 219 (1943). Congress directed the Commission to use its authority to make available a "rapid, efficient, Nation-wide, and world-wide wire and radio communication service." 47 U.S.C. 151. It made clear that the FCC's jurisdiction extends to "all interstate and foreign communication by wire or radio." 47 U.S.C. 152(a).

1. The federal courts of appeals have consistently recognized that the FCC is authorized to preempt inconsistent state practices in order to achieve the goals set forth in Section 151. For example, the Fourth Circuit's decision in *North Carolina Util. Comm'n* v. *FCC*, 537 F.2d 787, cert. denied, 429 U.S. 1027 (1976) (*NCUC I*), involved the issue of whether telephone terminal equipment supplied by the customer rather than by the telephone company could be connected to the telephone network. Two state commissions had indicated that such equipment could not be attached to facilities used for intrastate service, and the FCC ruled that the state prohibitions were preempted by federal policies permitting interconnections for interstate service (537 F.2d at 790). The court of appeals determined that "it is not feasible * * * to limit the use of such equipment to either interstate or intrastate transmissions" (*id.* at 791). Accordingly, the FCC's policies "unavoidably affect[ed] intrastate as well as interstate communication" and, by the same token, both interstate and intrastate communications would be affected by state action preventing connection of customer provided equipment (*id.* at 792). In these circumstances, the court held, the FCC must be permitted to preempt the states.

The District of Columbia Circuit came to a similar conclusion in *Computer & Communications Industry Ass'n* v. *FCC*, 693 F.2d 198 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983), which involved the FCC's deregulation of customer premises terminal equipment (CPE) and some aspects of enhanced communications services.[16] The FCC declared that state commissions were preempted from regulating CPE and enhanced services. As the court of appeals explained, "[t]he conflict between federal and state power over CPE arises because most CPE in this country is used interchangeably for both interstate and intrastate communication and has traditionally been subject to both state and federal regulation" (693 F.2d at 214). If states regulated CPE and enhanced services under interstate tariffs, that would conflict with the FCC's goal of establishing a competitive market for CPE and enhanced services (*id.* at 215). The court of appeals concluded that "the Commission's jurisdiction is paramount and conflicting state regulations must necessarily yield to the federal regulatory scheme" (*id.* at 214; footnotes omitted).[17]

---

[16] "Enhanced service" typically involves access to information stored in a computer. It is contrasted with "basic service," the transmission of communications. See 693 F.2d at 205 n.18.

[17] A number of other decisions have upheld the FCC's authority to preempt. *E.g.*, *New York Tel. Co.* v. *FCC*, 631 F.2d 1059 (2d Cir. 1980); *California* v. *FCC*, 567 F.2d 84 (D.C. Cir. 1977), cert. denied, 434 U.S. 1010 (1978); *Puerto Rico Tel. Co.* v. *FCC*, 553 F.2d 694 (1st Cir. 1977); *North Carolina Util. Comm'n* v. *FCC*, 552 F.2d 1036 (4th Cir.), cert. denied, 434 U.S. 874 (1977) (*NCUC II*); *Sherdon* v. *Dann*, 193 Neb. 768, 229 N.W.2d 531 (1975); cf. *General Tel. Co.* v. *FCC*, 449 F.2d 846 (5th Cir. 1971).

2. As the Fourth Circuit recognized in this case, the FCC's depreciation orders were devised to help achieve the objectives set forth in Section 151 (J.S. App. A11).[18] After extensive rulemaking proceedings in which it received and considered comments from state commissions and independent analysts as well as industry representatives, the FCC found that changes in the nature of the industry mandated changes in its depreciation policies. The Commission determined that its new policies would speed the re-

[18] Citing this Court's decision in *Pacific Gas & Electric Co.* v. *State Energy Resources Conservation & Development Comm'n*, 461 U.S. 190 (1983), petitioners contend (Cal. Br. 29) that the FCC and the Fourth Circuit could not look to the broad mandate of Section 151 to justify preemption. *Pacific Gas & Electric Co.* is clearly distinguishable, however. In that case California had adopted a statute which effectively prevented construction of new nuclear power plants until some effective plan for dealing with nuclear waste was devised. In the face of a federal statute that "allowed the States to determine—as a matter of economics—whether a nuclear plant vis-a-vis a fossil fuel plant should be built" (*id.* at 222) and limited federal regulation to safety regulation (*id.* at 207-208, 212), this Court concluded that the broad purpose of the Atomic Energy Act to promote the use of nuclear power was an insufficient basis for preemption of the California statute. The Communications Act is not analogous to the Atomic Energy Act. The FCC is not restricted to a narrow concern such as safety regulation and the states are not given authority to control the development of the telephone network. On the contrary, the FCC has a "comprehensive mandate" and "expansive powers" (*National Broadcasting Co., supra,* 319 U.S. at 219). In addition, as we show (pages 23-32, *infra*), Section 220 of the Communications Act grants the FCC specific authority over depreciation rates. Thus, preemption in this case is not based merely on the FCC's broad authority under Section 151, but on the combination of that authority and the agency's specific authority under Section 220.

covery of capital, provide incentives to modernize plant, simplify regulation and make it more rational, and impose costs more nearly on the users who caused them. These are legitimate regulatory objectives within the FCC's broad mandate.[19]

Petitioners suggest that because regulators traditionally have separated the costs of jointly-used facilities there need not be a conflict here since the FCC could confine its depreciation regulation to the portion assigned to the interstate jurisdiction. *E.g.*, La. Br. 40-41; National Conference of State Legislators Br. 14. In their view, any conflict is removed if the telephone companies maintain one set of accounts for

[19] Claims to the contrary by the petitioners are based on assertions that the FCC's policies will not achieve their goals. Petitioners argue, for example, that faster depreciation will frustrate the FCC's plans because it will produce higher rates and discourage the use of carrier facilities. Cal. Br. 37; TRACER Br. 10-16. As an initial matter, the FCC was aware that its actions likely would result in short-term rate increases and it took that fact into consideration when it made its policy changes. See *ELG Order*, J.A. 23, 35. The FCC concluded that on balance the long-term benefits to the public of rational depreciation policies outweighed the short-term costs. In any event, such arguments provide no basis for overturning the FCC's *Preemption Order* because they challenge the wisdom of the substantive depreciation policies rather than the lawfulness of preemption. The FCC's depreciation policies rest on precisely the kind of predictive judgment that is committed to the FCC's discretion (and that is, of course, subject to future re-evaluation by the FCC in the light of experience). See *FCC* v. *WNCN Listeners Guild*, 450 U.S. 582, 595 ([illegible]); *American Tel. & Tel. Co.* v. *United States*, 299 U.S. 232 (1936). Moreover, as we pointed out above, no party sought review of the FCC's substantive depreciation decisions. They may not now ask the courts to second-guess those decisions in a case that concerns the preemptive effect of the FCC's depreciation policies.

the FCC and another for state commissions. It is apparent, however, that the goals the FCC sought to achieve with its depreciation policies could be frustrated by inconsistent state depreciation practices, just as the state actions that were preempted in *NCUC I* and *Computer & Communications Industry Ass'n* could have impeded the achievement of federal goals. As the FCC pointed out, approximately 75% of the cost of jointly-used plant is allocated to the intrastate jurisdiction. The FCC's objective of allowing carriers adequate capital recovery to enable them to modernize their facilities could not be achieved if the FCC's substantive depreciation policies applied only to 25% of the cost of the network. Inconsistent state depreciation practices that delay recovery of capital would discourage investment in new equipment, thus slowing modernization of the interstate as well as the intrastate telephone network.[20] In short,

[20] Therefore, it is not inconsistent for the FCC to permit state commissions to authorize carriers to use depreciation rates for intrastate ratemaking that permit faster capital recovery than those adopted by the FCC, as Louisiana suggests (Br. 29). The FCC's objectives are not undermined by state regulation permitting faster capital recovery. In any event, no one has complained to the FCC of such state regulation and the FCC has not expressly approved or disapproved of it.

Nor is there merit to petitioners' suggestion (La. Br. 29) that the *ELG Order* cannot be preemptive because the order itself is merely permissive, allowing, but not requiring, carriers to adopt equal life group and remaining life procedures. The FCC order was optional because some carriers lack the extensive data bases and data processing resources needed to use these methods. J.A. 36, 40. State action which *forbids* the carriers to do that which the FCC deliberately and expressly has *permitted* them to do is in conflict with the federal order and thus may be preempted. See *New York State Comm'n* v. *FCC*, 669 F.2d 58, 66 (2d Cir. 1982) (federal regulation which is permissive in its approach may preempt restrictive state regulation). In any event, the FCC's subsequent prescription orders for individual companies made the use of the new procedures mandatory where feasible. *E.g., Prescription of Revised Percentages of Depreciation*, 96 F.C.C.2d 257 (1983).

the depreciation policies adopted by the FCC will not achieve the agency's legitimate objectives unless state commissions follow them. And, as events following the issuance of the *Preemption Order* illustrate, state commissions, which are generally under great pressure to keep customer rates low, may sacrifice the long-term efficiency of the telephone network to short-term goals.[21] In light of the FCC's powers under Section 151 and its broad jurisdiction under Section 152(a), the FCC acted within the scope of its authority in preempting the states from requiring telephone companies to use inconsistent depreciation methods.[22]

B. Section 220 Plainly Authorizes The FCC To Preempt Inconsistent State Practices Regarding Depreciation Methods And Rates

Any doubt about the FCC's authority to preempt in this case is laid to rest by Section 220. Section 220(b) plainly authorizes the FCC to issue preemptive orders regarding depreciation methods and rates.

[21] Congress recently noted that state commissions, "in an effort to keep local rates low," have favored depreciation methods that do not "encourage modernization." H.R. Rep. 98-479, 98th Cong., 1st Sess. 53 (1983).

[22] California also argues (Br. 5) that states must retain control over depreciation charges because the FCC cannot take account of local conditions in making depreciation prescriptions. This argument ignores the fact that although the Commission has adopted general policies that apply nationwide, it makes individual prescriptions for telephone companies in consultation with state commissions. The FCC does not mechanically prescribe depreciation rates without regard to local conditions.

The legislative history of Section 220 and its structure show that Congress intended the FCC to prescribe preemptive depreciation rates.

1. Section 220(b) directs the FCC to prescribe depreciation methods and rates for carriers subject to the Act. It plainly states that those depreciation prescriptions are exclusive: once the FCC prescribes depreciation rates for carriers subject to the Act, "[s]uch carriers shall not * * * charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or * * * charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission." Section 220 reserves no complementary authority for state commissions.[23] Thus, under the standard assumption that " 'the legislative purpose is expressed by the ordinary meaning of the words used' " (*Kosak* v. *United States*, No. 82-618 (Mar. 21, 1984), slip op. 5, quoting *American Tobacco Co.* v. *Patterson*, 456 U.S. 63, 68 (1982), and *Richards* v. *United States*, 369 U.S. 1, 9 (1962)), the FCC has authority to issue preemptive depreciation prescriptions.

Petitioners complain (see La. Br. 37-38) that the FCC did not claim the authority to issue preemptive depreciation prescriptions for almost 50 years, contending that the delay shows that it thought it lacked power to preempt. The actual history of past practice does not support this contention. Although the FCC had not ruled previously on the preemptive effect of its depreciation prescriptions, there had been no occasion to do so. The preemption issue had not arisen because the states generally had gone along with the FCC's prescriptions. The state commissions participated in general prescription proceedings and in the three-way meetings to set depreciation rates for individual carriers, and there had been no direct challenges to the FCC's prescription orders. The FCC had made clear that it would not object to minor departures from its accounting rules so long as there was no conflict, giving blanket approval to state-required "subaccounts" provided the subaccounts did not impair the integrity of the uniform accounting system. See 47 C.F.R. 31.01-2(d)(1). Such accommodations, obviously, are as consistent with the existence of preemptive authority as with its absence.

Nor does the FCC's first decision in this case show that it lacks power to preempt. The evolution of this case shows only that FCC was not eager to preempt. In its original order, the FCC found "no occasion" to preempt because it believed that the states would act in a way that was reconcilable with federal policies.

[23] This is in contrast to sections of the Act which do expressly confine the FCC's regulatory authority to interstate and foreign communications. See, *e.g.*, Section 201(a) ("every common carrier engaged in interstate or foreign communications" must furnish service on reasonable request); Section 203(a) (carriers must file tariffs with the FCC "for interstate and foreign * * * communications"); Section 214(a) (requirement of FCC certificate for new lines does not apply to "a line within a single State unless such line constitutes part of an interstate line").

Amici contend that Section 220 does distinguish between interstate and intrastate facilities because it applies to "carriers subject to the Act." *E.g.*, Alabama Br. 6. The assumption underlying this contention is that local exchange carriers are not subject to the Act. However, virtually all carriers are "subject" to some substantive provisions of the Act. Section 152(b) provides that even those local carriers "engaged in interstate or foreign communication solely through physical connection with the facilities of another carrier" are subject to Sections 201 through 205, the ratemaking provisions of the Act.

The FCC declared its rulings to have preemptive effect only after it became clear that state commissions would not follow them (J.S. App. A46 n.14, A48-A49). Moreover, the FCC "is not disqualified from changing its mind; and when it does, the courts still sit in review of the administrative decision and should not approach the statutory construction issue *de novo* and without regard to the administrative understanding of the statutes." *NLRB* v. *Local Union No. 103*, 434 U.S. 335, 351 (1978).[24]

2. a. The legislative history of Section 220 establishes beyond doubt that the FCC's authority to prescribe depreciation methods and rates includes authority to preempt inconsistent state practices. Congress modeled Section 220 on Section 20 of the Interstate Commerce Act, 49 U.S.C. (1976 ed.) 20 (repealed). S. Rep. 781, 73d Cong., 2d Sess. 5 (1934); H.R. Rep. 1850, 73d Cong., 2d Sess. 7 (1934). Congress had amended Section 20 in 1920, directing the Interstate Commerce Commission to prescribe depreciation methods and rates for telephone companies. *Northwestern Bell Telephone Co.* v. *Nebraska State Ry. Comm'n*, 297 U.S. 471, 477 (1936). The ICC viewed its powers under Section 20 as covering "local

[24] The statement of the California Supreme Court that the California commission was "not bound by the depreciation rates or methods" set by the FCC (*Pacific Tel. & Tel. Co.* v. *California*, 44 Cal. Rptr. 1, 20-21, 401 P.2d 353, 372-373 (1965)), which petitioners cite (Cal. Br. 3; La. Br. 27), does not support petitioners' argument. That statement was made without any analysis of Section 220 and its history and without participation by the FCC. Moreover, the court was dealing with a minor point in a broad dispute. Its statement does not indicate any general understanding that the FCC could not issue preemptive depreciation prescriptions.

properties of telephone companies where used to some extent in interstate toll service." *Depreciation Charges*, 118 I.C.C. 295, 330-333 (1926). In short, Congress modeled Section 220(b) on a provision that the ICC had determined to be preemptive and stated plainly, in the text of the statute, that the depreciation methods and rates to be prescribed by the FCC were to be exclusive (see page 24, *supra*). Thus, the FCC's decision that the depreciation practices it prescribed preempt inconsistent state practices is expressly authorized by Congress.[25]

b. That the FCC has authority to preempt in this case is shown with particular clarity by the fact that in 1934 Congress specifically rejected a proposal that would have given the state commissions the authority they now seek. As orginally proposed, Section 220 included a new subsection, Section 220(j), that would have reserved to the states the authority to set depreciation rates for intrastate ratemaking purposes. Section 220(j), as proposed, provided that nothing in the statute would "limit the power of a State commission to prescribe, for the purposes of the exercise of its jurisdiction with respect to any carrier, the percentage rate of depreciation to be charged to any

[25] The cases decided by this Court construing Section 20 do not show that it did not grant the ICC preemptive authority, as petitioners suggest (Cal. Br. 20; La. Br. 3-4). The Court in those cases decided only that "until the Interstate Commerce Commission has prescribed depreciation rates the prerogative of the state to regulate such rates cannot be gainsaid." *Northwestern Bell, supra*, 297 U.S. at 479; *Smith* v. *Illinois Bell Telephone Co.*, 282 U.S. 133, 159-160 (1930). Indeed, the language used by the Court suggests that once the ICC acted the states would be preempted. See *New York Tel. Co.* v *.FCC*, 631 F.2d at 1066-1067.

class of property." [26] The House Committee report and the House bill's sponsor in floor remarks acknowledged that Section 220(j) as proposed would "change" the existing law by removing limitations in Section 20 of the Interstate Commerce Act on the authority of the states to prescribe rates of depreciation. H.R. Rep. 1850, 73d Cong., 2d Sess. 7 (1934); 78 Cong. Rec. 10314 (1934) (remarks of Rep. Rayburn).

Opposition to that change was voiced at the Senate hearings on the bill. The president of AT&T vigorously attacked the new subsection, claiming that it, along with subsection (h)—which authorizes the FCC to exempt carriers from federal requirements where they are subject to state regulation—"strike down practically all the sound and salutatory provisions of the preceding paragraphs, and introduce chaos."

[26] Section 220(j), as initially proposed in S.2910, 73d Cong., 2d Sess. (1934) and H.R. 8301, 73d Cong., 2d Sess. (1934), provided:

> (j) Nothing in this section shall (1) limit the power of a State commission to prescribe, for the purposes of the exercise of its jurisdiction with respect to any carrier, the percentage rate of depreciation to be charged to any class of property of such carrier, or the composite depreciation rate, for the purpose of determining charges, accounts, records, or practices; (2) relieve any carrier from keeping any accounts, records, or memoranda which may be required to be kept by any State commission in pursuance of authority granted under State law.

This language is strikingly similar to language that Congress enacted in almost contemporaneous legislation dealing with depreciation regulation in the natural gas and electric power industries. See Section 9(a), 15 U.S.C. 717h(a) (Natural Gas Act); Section 302(a), 16 U.S.C. 825a(a) (Federal Power Act). The rejection of this language in the Communications Act indicates that Congress made a different decision with respect to the communications industry.

Federal Communications Commission: Hearings on S. 2910 Before the Senate Comm. on Interstate Commerce, 73d Cong., 2d Sess. 96 (1934) [hereinafter cited as *Senate Hearings*]. Noting the conflict between subsections (b) and (j), he described the section as "mak[ing] an orderly advance and then beat[ing] a disorderly retreat" (*ibid.*). The committee took careful note of these objections, asking the president of the United States Independent Telephone Association and the chairman of the legislative committee of the National Association of Railroad and Utilities Commissioners (NARUC) to respond to them (*id.* at 140, 154). The ICC responded in writing, one day after the conclusion of the Senate hearings, stating that Section 220(j) "unquestionably directly conflicts with, and destroys the uniformity of systems of accounts and depreciation accounting required by the preceding provisions of the section. That is not true under present law" (*Senate Hearings* 208). The ICC advised that this change "should be most carefully considered" (*ibid.*). The Senate responded by drafting a new subsection (j) providing that the FCC "shall investigate and report" on whether state commissions should be permitted to prescribe depreciation rates.[27]

[27] The Senate revised Section 220(j) to provide:

> (j) The Commission shall investigate and report to the Congress whether in its opinion legislation is desirable (1) authorizing the Commission to except the carriers of any particular class or classes in any State from any of the requirements under this section in cases where such carriers are subject to State commission regulation with respect to matters to which this section relates; and (2) permitting the State commissions, in pursuance of authority granted under State law, to prescribe their own percentage rates of depreciation or systems of accounts, records, or memoranda to be kept by carriers.

The House held hearings on the proposed legislation after the Senate had revised Section 220(j). The House bill under consideration retained the version of Section 220(j) that authorized state commissions to prescribe depreciation practices. The chairman of NARUC's legislative committee stated that he opposed the Senate's revision, stating that the Senate bill "has been redrafted so that certain of the provisions are altered in such a way as to perhaps result in crippling State regulation of accounts and depreciation in a very vital way," *Federal Communications Commission: Hearings on H.R. 8301 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 70 (1934) [hereinafter cited as *House Hearings*]. NARUC's general solicitor stated bluntly, with respect to Section 220(j), that "[t]hat matter is all right in this bill and all wrong in the last draft of the Senate bill" (*House Hearings* 137). He recommended responding to the conflict between subsections (b) and (j) identified by AT&T's president by revising Section 220(b). Specifically, he proposed amending Section 220(b) to provide that carriers were forbidden to use depreciation rates other than those prescribed by the FCC "in the accounts prescribed by the commission" in place of Section 220(b)'s flat prohibition of the use of depreciation rates other than those prescribed by the FCC (*id.* at 144). The bill passed the House without significant modification of Section 220.

The Conference Committee essentially adopted the Senate's version of Section 220(j).[28] Contrary to

[28] As signed by the President, Section 220(j) provided:

(j) The Commission shall investigate and report to Congress as to the need for legislation to define further or harmonize the powers of the Commission and of State

NARUC's suggestion, Section 220(b) was not changed. Thus, Congress clearly intended that the FCC would prescribe uniform depreciation rates, and, after it did, that telephone companies would not use any other depreciation rates, as Section 220(b) plainly states.[29]

3. The resulting structure of Section 220 further supports the conclusion that Congress intended the FCC to have authority to prescribe preemptive depreciation methods and rates. Congress responded

commissions with respect to matters to which this section relates.

A comparison of this version of Section 220(j) with the version as introduced (see note 26, *supra*) and the version as revised by the Senate (see note 27, *supra*) clearly refutes California's contention (Br. 23-24) that Section 220(j) is a compromise provision that does not assume that the FCC has authority to preempt. Section 220(j) as enacted is a condensed version of the Senate's revision.

[29] Subsequent legislative history supports the FCC's *Preemption Order* as well. First, as we explain (page 36-37, *infra*), Congress in 1971 enacted Section 410(c), which generally provides for FCC control over matters affecting interstate and intrastate communications while providing for consultation with state representatives. Second, Congress considered a bill that would have overturned the *Preemption Order* in 1983. H.R. Rep. 98-479, 98th Cong., 1st Sess. 53 (1983). Congress did not enact that bill. Moreover, while the bill would have given state commissions authority to prescribe depreciation methods and rates (see H.R. 4102, 98th Cong., 1st Sess. § 7 (1983)), it would also have placed constraints on the state commissions. Congress recognized that "in an effort to keep local rates low" state commissions had preferred depreciation methods that are not designed to encourage modernization of plant. H.R. Rep. 98-479, *supra*, at 53. Accordingly, the bill considered by Congress would have required state commissions to use the remaining life method (*id.* at 54).